February 6, 2023

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Principles for Climate-Related Financial Risk Management for Large Financial Institutions (Docket No. OP-1793; 87 Fed. Reg. 75,267)

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the draft principles captioned above ("principles"),[2] issued by the Board of Governors of the Federal Reserve System ("Federal Reserve"), for both banks and supervisors to consider in the management and supervision of climate-related financial risks ("climate risks").

These principles are an important step in addressing climate risks, which can have serious effects on the safety and soundness of banks as well as overall financial stability. We appreciate the close collaboration between the banking agencies in developing their draft climate risk principles and for the Federal Reserve publishing draft principles that are materially similar to those of the Office of the Comptroller of the Currency ("OCC")[3] and the Federal Deposit Insurance Corporation ("FDIC").[4]

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies— including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] *See generally* Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 87 Fed. Reg. 75,267 (Dec. 8, 2022).

[3] *See generally* OFFICE OF THE COMPTROLLER OF THE CURRENCY, PRINCIPLES FOR CLIMATE-RELATED FINANCIAL RISK MANAGEMENT FOR LARGE BANKS (Dec. 16, 2021), https://www.occ.treas.gov/news-issuances/bulletins/2021/bulletin-2021-62a.pdf.

[4] *See generally* Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 87 Fed. Reg. 19,507 (Apr. 4, 2022).

Considering the broad range of risks that climate change can pose, we welcome the Federal Reserve's approach of largely integrating climate risks into existing risk management principles with some additions that capture unique aspects of these risks. In particular, the additions unique to climate risks are: the use of scenario analysis to identify and size risks, the consideration of longer time horizons, and the recognition that climate risks and their management are an evolving process. Importantly, we also welcome the Federal Reserve's additional emphasis—that is, beyond the OCC and FDIC—on the differences in responsibilities of boards and senior management, with special emphasis on boards being ultimately accountable for issues that arise. We urge the Federal Reserve to finalize these principles with some enhancements, as discussed below, and to fully incorporate them into the supervisory assessment process.

First, considering the evolving nature of climate risks, the current absence of mandated measurements or metrics, and that the development of so-called best practices is in early stages, the Federal Reserve should, within its principles, set an expectation that banking institutions look to available, internationally agreed-upon and published metrics and best practices for use as a benchmark to, or even direct use in, their own internally developed risk management practices. This expectation would include data collection and metrics, risk measurement, risk management thresholds, modeling, and reporting.

Second, such an expectation should also be included with regard to scenario analysis, for which the principles similarly should include promotion of banking institutions' use of internationally agreed-upon scenarios and scientific projections to ensure plausibility and a minimum level of severity of their own scenarios.

Third, also specific to scenario analysis, because climate risks introduce unique and potentially catastrophic financial stability risks, the principles should include the expectation that macroprudential elements designed to capture second-order, systemic risks be included in scenario analysis.

Fourth, while issuing principles-based guidance is a necessary step in including climate risks in the supervisory assessment process, given actions taken in the recent past, guidance alone is unlikely to prompt banks to adopt suitable practices to address climate risks. Indeed, a rule proposed by the Federal Reserve, the FDIC, the OCC, the National Credit Union Administration, and the Bureau of Consumer Financial Protection ("the Agencies") in 2020[5] and adopted by the Federal Reserve in April of 2021[6] seriously undermined supervisors' effectiveness by limiting the role of supervisory guidance in issuing supervisory findings and by extension informing supervisory ratings. As such, we urge the Federal Reserve to work with the other regulatory agencies to rescind this rule so that guidance can achieve its intended effect of getting banks to develop and use better practices with respect to managing all risks, including those from climate change.

[5] *See generally* Role of Supervisory Guidance, 85 Fed. Reg. 70,512 (proposed Nov. 5, 2020).
[6] *See generally* Role of Supervisory Guidance, 86 Fed. Reg. 18,173 (Apr. 8, 2021).

Comments

I. The Proposed Principles Take the Appropriate Approach of Largely Integrating Climate Risks into Existing Risk Management Principles and of Making Boards and Senior Management Accountable

Climate change has been recognized in the U.S. and internationally as posing a threat to the safety and soundness of banks as well as overall financial stability. Numerous global regulatory authorities and organizations have made this recognition – the central banks of Japan, the United Kingdom, France, Germany, the Netherlands, the United States, and others as well as inter-agency and international bodies such as the U.S. Financial Stability Oversight Council, the Bank for International Settlements, and the Financial Stability Board. As they are broadly recognized and clearly material, climate risks must be a part of banks' risk management and governance practices, and assessing those must be part of the supervisory assessment processes of bank regulatory authorities. An integral part of that incorporation is including climate risks in supervisory guidance. More important still is including such risks in supervisors' assessment criteria that feeds into the final supervisory ratings.

Banks themselves are the "first line of defense" in identifying, sizing, and managing risks, and so it is necessary for banks to ensure they have strong and robust risk management and governance processes in place, whereas it is the responsibility of prudential regulators to assess banks' processes and hold banks accountable when they are not effective. Put another way, it is the responsibility of banks to design and execute processes that are necessary to effectively manage their risks on a day-to-day basis. The responsibility of prudential regulators is to assess the risk management and governance processes at banks and to take supervisory actions to require banks to fix weaknesses in those processes that are identified through supervisory assessments.

Principles-based guidance does not explicitly outline all aspects of supervisory expectations, and so the principles themselves must be well-founded and specific enough to make the intention of the expectation clear and to promote safe and sound practices, but also general enough to allow for evolution and innovation in the development of current best practices. The proposed principles mostly achieve this goal by integrating climate risks into the existing principles framework for the risk management and governance of more "traditional" risks—such as credit, market or operational risks—as a starting point and adding components to the principles to capture certain aspects that are unique to climate risks.

Indeed, nearly all the proposed principles for climate risks align one-for-one with those of traditional risks. This is sensible and appropriate because climate risks are a risk to safety and soundness just as with more traditional risks and can manifest as more traditional risks. For example, changes in weather patterns could significantly decrease the output of farmland that collateralizes a loan, thereby harming the farmland's income and its inherent value. This would have the effect of increasing both the probability of default on the loan and the loss given default.

Importantly, the proposed principles focus on the governance of climate risks and the responsibility of boards of directors and senior management. Senior management is responsible

for the day-to-day management of all risks to a bank, and boards of directors are ultimately responsible for overseeing the risk management and governance processes as well as holding senior management accountable for ensuring sufficient and effective risk management and governance processes. Both parties must have sufficient knowledge and understanding of climate risks to fulfill those responsibilities. Key to the proposed principles around governance is the emphasis on a bank ensuring that their board and senior management has sufficient knowledge and understanding of climate risks and the impact on a bank's strategic direction, business model, and risk appetite. Considering the evolving nature of climate risks and that they are likely newer to and less understood by boards and senior management, this emphasis is needed to avoid an incentive to pass on responsibility of the management of climate risks to lower-level employees and claim ignorance.

Furthermore, the Federal Reserve's proposed principles – as compared to those of the OCC and FDIC – rightly emphasize the distinction between the responsibilities of the board and senior management as well as note that the board must take action by adjusting compensation policies when warranted:

> "The board should consider whether the incorporation of climate-related financial risks into the financial institution's overall business strategy and risk management frameworks may warrant changes to its compensation policies, taking into account that compensation policies should be aligned with the business, risk strategy, objectives, values, and long-term interests of the financial institution."[7]

Such action would strongly incentivize senior management to address issues related to the management of climate risks.

In this regard, the principles also sensibly discuss the assignment of climate risks by board members and senior management to specific members and committees. This targeted assignment can help ensure that climate risks are actively managed and that assigned parties have the necessary knowledge and understanding and can be held accountable for any issues that arise. Additionally, with clearly defined responsibilities, identified risks can be escalated more easily and efficiently and understood by each responsible party along the chain of escalation.

Furthermore, the measurement of climate risks is a central theme throughout the principles, a foundational aspect of risk management. That is, measurement and analysis of risks are foundational to their identification, sizing, management, and mitigation. In the spirit of treating climate risks similar to other more traditional risks, the principles reasonably promote the measurement and tracking of climate risks—just as with other risks—through risk management processes such as: data aggregation; qualitative or quantitative metrics or indicators to assess, monitor, and report climate risks; materiality thresholds; key risk indicators that align with their regular monitoring and escalation arrangements; and internal risk limits for the various types of material climate risks. However, the language around data and measurement should be more instructive, as discussed in more detail below.

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[7] Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 87 Fed. Reg. at 75,269.

Outside of the more standard risk management principles, the Federal Reserve has made some welcome additions. The Federal Reserve recognizes the key point that risks arising from climate change are as evolving as climate change itself, a point that defines a major distinguishing factor of climate risks and one that is the basis for two additions specific to climate risks that are beyond existing risk management principles. First, the Federal Reserve recognizes that climate risks can materialize over longer time horizons as compared to more traditional risks and that banks must consider this in their management of climate risks. This is true for both physical and transition risks. Such recognition is necessary for climate risks to be properly considered and managed and encourages banks to think about how the risks will evolve over time and take or plan for actions accordingly. Second, the principles specifically note the use of scenario analysis as a critical tool for sizing and identifying climate risks. Scenario analysis is widely recognized as an important tool for assessing evolving risks that can take many different paths over varying time horizons. These additions will promote banks to be both nimble and forward-looking, necessary qualities for managing climate risks.

Additionally, the Federal Reserve has sensibly recognized that many banks have made significant public commitments to modify their business practices to facilitate the transition to a low-carbon economy and that these commitments should align with their internal climate risk management practices, such as internal risk limits. Indeed, if there is no alignment, supervisors and the public are left to wonder if the commitments are valid and, by extension, if banks are effectively managing their risk.

Finally, it is important that the Federal Reserve has included the consideration of disproportionate impacts on low-to-moderate income and other disadvantaged households and communities. These communities do indeed experience disproportionate effects from the fallout of more traditional risks, as they did during and after the 2008 global financial crisis. Not only could a similar impact to these communities result from climate risks but there are other impacts that could also result from climate risks, such as the closing of branches due to weather-related events. More directly, it has been shown that climate shocks and stresses disproportionately impact low-income communities and economically marginalized communities of color.[8]

II. Measurement is the Linchpin to Effective Risk Management, and So the Principles Should Promote Minimum Standards for Measurement of Climate Risks

Being able to measure climate risks and exposures is foundational to almost all categories of risk sources outlined in the principles—capital and liquidity adequacy, the risk management process, management monitoring and reporting, and the comprehensive management of credit, market, liquidity, operational and other risks. The principles appropriately cover the fundamental risk management processes: data aggregation; qualitative or quantitative metrics or indicators to assess, monitor, and report climate risks; materiality thresholds; key risk indicators that align with their regular monitoring and escalation arrangements; and internal risk limits for the various types of material climate risks.

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[8] ELIZABETH MATTIUZZI & EILEEN HODGE, FED. RSRV. BANK OF S.F., CLIMATE-RELATED RISKS FACED BY LOW AND MODERATE-INCOME COMMUNITIES AND COMMUNITIES OF COLOR: SURVEY RESULTS (2021), https://www.frbsf.org/wp-content/uploads/sites/3/climate-related-risks-faced-by-low-and-moderate-income-communities-and-communities-of-color-survey-results.pdf.

Without sufficient measurement techniques and criteria, banks will not be able to properly execute on any of these risk management processes. For example, without reliable measurement techniques the process of simply determining which climate risks rise to the level of being material could yield unreliable results or under-estimate the amount of material climate risks to the bank. Similarly, in the process of setting risk limits and monitoring levels of risk against those limits, if data and measurements are unreliable, then not only would the limits be unreliable but so would the measurements against them, potentially making the entire process a worthless exercise.

So, while it is beneficial that the principles encourage banks to have "[e]ffective risk data aggregation and reporting capabilities" recognize that "data, risk measurement, modeling methodologies, and reporting continue to evolve at a rapid pace,"[9] they do not provide any guidance as to how banks should be managing the rapidly evolving nature. The continuous pace and scale of this evolution is unique to climate risks and make risk management processes more difficult to establish and more uncertain in their execution. Banks are working to establish their data collection, risk measurement, modeling, and reporting processes, but an examination of their publicly disclosed materials around climate risks shows that they are each approaching these processes in vastly different ways. This unique issue should be addressed in the proposed principles by promoting the use of or comparison to current climate risk data collection and measurement "best practices."

Considering the proposal is intended to support a principles-based approach to addressing climate risks, it is prudent not to be explicitly instructive as to which data to collect and which metrics to utilize. Discretion should be left to the banks so that they can collect data and design metrics and thresholds that are appropriate to the structure and risk profile of their business. That approach also allows for evolution and innovation within and among banks to create new best practices or improve upon existing practices.

However, given that climate risk management is in early stages and that there are not currently any generally accepted or required climate risk metrics and data collections, banks should not be left entirely to their own discretion. The supervisory principles should explicitly include the expectation for the direct use of or comparison to some best practices around data collection and metrics that have been developed, especially those developed on an international basis. That is, the guidance principles should state that as banks establish their risk management practices, they should be looking to, for example, international organizations such as the Financial Stability Board's Task Force on Climate-Related Financial Disclosures ("TCFD") or the United Nations International Panel on Climate Change ("IPCC") for their recommendations on data collection, climate risk measurements, and risk management as examples of best practices.

In fact, many banks are already doing exactly that. All the U.S. Global Systemically Important Banks are disclosing information that is aligned with the TCFD recommendations,

[9] Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 87 Fed. Reg. at 75,270.

with plans to increase the amount of such information, and are registered supporters[10] of the TCFD recommendations. The most recent TCFD annual report published by the Financial Stability Board shows that most firms disclosed at least some climate risks and opportunities aligned with their recommendations.[11] But just because some banks are voluntarily utilizing international recommendations does not mean there is no need to include the expectation of their use in the principles as examples of best practices. In fact, it is even more reason to do so.

Not only will the use of or comparison to measurements and data collection from broadly available best practices be beneficial to banks, but it would also be beneficial to supervisors, consumers, and market participants. It would help set minimum expectations for banks and promote broad-based general standards across the industry. Having baseline standards allows for comparison between banks, provides a consistent set of information for consumers and market participants, and allows for the aggregation of risks across banks.

As then-Governor Brainard stated in a speech, "without harmonization of the definitions and methods underlying these disclosures, it will be challenging to make comparisons across firms and exposures."[12] Data and risk aggregation support the monitoring of systemic risk build-up, which is critical to examining the safety and soundness of the system as a whole and is a key component to assessing overall financial stability within a country and across countries through collaboration or international supervisory organizations. This is especially important for climate risks, which are truly global.

III. Similarly, the Principles Regarding Scenario Analysis Lack the Expectation of Plausible Scenarios with Minimum Levels of Severity and Consideration for Systemic Risks

Similar to data collection and climate risk measurement, the principles leave too much discretion to banks regarding their scenario analysis. While it is positive that the principles identify scenario analysis as a key tool for banks to be using in sizing and assessing their climate risks, the principles fail to include language around the expectation of the use of plausible scenarios that have some minimum level of severity and inclusion of more macro-level, systemic risks that capture the unique threat climate risks pose to financial stability.

Again, discretion is an important component of a bank's internal risk management practices. For scenario analysis, it allows a bank to design scenarios that are specific and unique to its business model and risk profile and to create new scenarios that may not have been imagined by its peers or regulatory authorities. However, allowing too much discretion can lead to banks ignoring certain important aspects of climate change, designing scenarios that may not be as severe as generally accepted by the scientific community, or missing material and important financial stability risks.

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[10] See the full list of registered supporting institutions at https://www.fsb-tcfd.org/supporters/.
[11] *See* TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES, 2022 STATUS REPORT (2022), https://www.fsb.org/2022/10/2022-tcfd-status-report-task-force-on-climate-related-financial-disclosures/.
[12] Vice Chair Lael Brainard, Fed. Rsrv. Bd., Building Climate Scenario Analysis on the Foundations of Economic Research: Remarks at the 2021 Federal Reserve Stress Testing Research Conference (Oct. 7, 2021), https://www.federalreserve.gov/newsevents/speech/brainard20211007a.htm.

Therefore, the principles should include the expectation that banks directly use or benchmark their scenarios against internationally created scenarios and scientific projections, such as those produced by the Network for Greening the Financial System ("NGFS") or the climate projections created by the IPCC, to ensure some reasonable level of plausibility and severity. By looking to these scenarios and projections when designing their own scenarios, banks can determine a reasonable minimum level of severity.

In fact, as pointed out in Governor Brainard's speech (referenced above), international regulatory organizations that have already conducted climate scenario analysis have followed this model of using the scenarios produced by the NGFS as a starting point and tailoring them to capture local conditions, including the European Central Bank and financial regulators in Canada, France, and the United Kingdom.[13] Additionally, the Federal Reserve itself has aligned the scenarios within its 2023 pilot climate scenario analysis with scenarios and projections from the NGFS and IPCC.[14] If the Fed is going to do such alignment in its own scenario analysis, then it should also include the same in its principles. However, the Fed explicitly did not include the consideration of firm-specific risks, something that should be included in the principles.

Of course, banks must create scenarios that capture their unique risk profiles, but any material deviations from the benchmark scenarios that are in place to capture a bank's unique risks can be explained in a summary of its scenario analysis to note why the deviations were made. This is similar to how the current stress tests are designed and conducted and should be a practice that is utilized with climate scenario analysis as well. That is, in the U.S. the expectations for the stress test includes that the scenarios that banks use for their internal stress tests are plausible and are of similar severity as the scenarios that the agencies use themselves, while also being tailored to the unique risks at each bank.

Additionally, the principles should include the expectation that scenario analysis includes the consideration of systemic financial stability risks, such as those arising from interconnectedness and multiple financial market participants being affected simultaneously. In fact, this is an aspect that is even missing from the current stress tests that are used to set stress-based capital requirements, as pointed out by former Federal Reserve Governor Daniel Tarullo[15] and others. Such factors are even more important in the case of climate risks, because it is even more likely that physical and transition climate risks impact multiple financial organizations and financial markets simultaneously, bypassing the typical "cascading" impact of more traditional financial risks.

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[13] *See id.*

[14] *See* BD. OF GOVS. OF THE FED. RSRV. SYS., PILOT CLIMATE SCENARIO ANALYSIS EXERCISE: PARTICIPANT INSTRUCTIONS (2023), https://www.federalreserve.gov/publications/files/csa-instructions-20230117.pdf.

[15] *See* Daniel K. Tarullo, Harvard L. Sch., Rethinking the Roles of Stress Testing: Remarks Before the 2022 Federal Reserve Stress Testing Conference 9–13 (Oct. 7, 2022), https://subscriber.politicopro.com/f/?id=00000183-b372-d513-a19b-bbf6208d0000.

IV. The Federal Reserve Must Rescind the Rule Limiting the Role of Supervisory Guidance in the Supervisory Process

Supervisory criticisms, and the guidance that often informs them, are valuable tools that help prevent unsafe or abusive bank conduct from ripening into outright violations of law, dangerous instability, and consumer harm. The rule proposed by the Agencies in 2020 and finalized by the Federal Reserve in April of 2021 has limited the role of supervisory guidance in the final stage of issuing supervisory assessments of banks for unsafe or unsound practices. It is now more difficult for bank supervisors to hold banks—including the largest banks, which can pose a direct threat to financial stability and the economic wellbeing of the public when badly managed—accountable for dangerous practices, poor management, and ineffective oversight by bank boards of directors in a principles-based supervisory approach. This applies as well to the proposed principles for climate risks.

As such, the Federal Reserve – along with the other regulatory agencies – must rescind the rule so that these principles, as well as all other principles that are part of supervisory guidance, would have their intended impact.

V. The Federal Reserve, FDIC, and OCC Should Extend their Principles to Banks with Fewer than $100 Billion in Assets

While we commend the Federal Reserve's higher attention to the climate risk faced by large banking organizations, we urge wider consideration of such risk in the financial system, particularly at regional banking organizations ("RBOs").[16] The Federal Reserve itself recognizes that "all financial institutions, regardless of size, may have material exposures to climate-related financial risks,"[17] which obviously includes RBOs. For instance, the Federal Reserve's most recent Supervision and Regulation Report notes that RBOs "are highly concentrated in [commercial real estate or] CRE lending and have higher CRE concentrations than larger banks."[18] Since the Federal Reserve's own recent pilot exercise on climate scenario analysis uses similar CRE loan portfolios to gauge exposure to physical risk,[19] it should follow that RBOs need their own guidance on how to identify and manage physical and other climate-related risks.

Nearly all of the principles as drafted apply as well to RBOs as to the largest banks, and, therefore, extending them to supervision of RBOs would be appropriate given those banks' size, scope, or operations. As noted above, extending these principles is particularly useful to the extent that climate risk has macroprudential or systemic implications. The Federal Reserve should therefore move ahead with similar principles applicable to RBOs unless and until it

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[16] "Regional banking organizations" here refers to those institutions with total assets between $10 and $100 billion. *See, e.g.*, *Federal Reserve Supervision and Regulation Report*, FED. RSRV. (Nov. 12, 2020), https://www.federalreserve.gov/publications/2020-november-supervision-and-regulation-report-supervisory-developments.htm.

[17] Principles for Climate-Related Financial Risk Management for Large Financial Institutions, 87 Fed. Reg. at 75,268.

[18] BD. OF GOVS. OF THE FED. RSRV. SYS., SUPERVISION AND REGULATION REPORT 28 (2022), https://www.federalreserve.gov/publications/files/202211-supervision-and-regulation-report.pdf.

[19] *See* BD. OF GOVS. OF THE FED. RSRV. SYS., PILOT CLIMATE SCENARIO ANALYSIS EXERCISE: PARTICIPANT INSTRUCTIONS 5 (2023), https://www.federalreserve.gov/publications/files/csa-instructions-20230117.pdf.

receives clear evidence that supervision of climate risk at RBOs requires different guidance. The agency should also do so in coordination with extensions of similar principles by the FDIC and OCC.

Conclusion

Better Markets is supportive of the Federal Reserve to fully incorporate climate risks into the supervisory assessment process. The proposed principles are a significant and positive step in doing so, and we urge the Federal Reserve to finalize these principles as soon as possible and incorporate the enhancements we discuss above.

Sincerely,

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